

Office of the State Auditor
Division of State Audit

North Dakota Lottery
Bismarck, North Dakota

Audit Report for the
Year Ended June 30, 2005
Client Code 125.1

Robert R. Peterson
State Auditor



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INDEPENDENT AUDITOR'S REPORT

Honorable John Hoeven, Governor
Members of the Legislative Assembly

Chuck Keller, Director
North Dakota Lottery

We have audited the accompanying financial statements of the North Dakota Lottery, a division of the Office of the Attorney General, state of North Dakota, as of and for the period ended June 30, 2005, which collectively comprise the North Dakota Lottery's basic financial statements as listed in the table of contents. These financial statements are the responsibility of North Dakota Lottery management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As discussed in Note 1, the financial statements of the North Dakota Lottery are intended to present the financial position, and the changes in the financial position and cash flows of only that portion of the business-type activities of the state of North Dakota that are attributable to the transactions of the North Dakota Lottery. They do not purport to, and do not, present fairly the financial position of the state of North Dakota as of June 30, 2005, and the changes in its financial position and its cash flows, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the North Dakota Lottery, as of June 30, 2005, and the respective changes in the financial position and cash flows thereof for the period then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 21, 2005, on our consideration of the North Dakota Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 7 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Robert R. Peterson
State Auditor

October 21, 2005

NORTH DAKOTA LOTTERY

Management's Discussion and Analysis

For the Fiscal Year Ended June 30, 2005

This Management's Discussion and Analysis is for readers of the Lottery's financial statements and is an overview of the Lottery's financial activity for the fiscal year ended June 30, 2005. This analysis is to be considered in conjunction with the financial statements to provide an objective analysis of the Lottery's financial activity based on facts, decisions, and conditions that presently face the director.

Understanding the Lottery's Financial Statements

The Lottery, a division of the Office of Attorney General, is accounted for as an enterprise fund that reports all income, expenses, assets, and liabilities using the accrual basis of accounting, like a private business entity. In accordance with generally accepted accounting principles, this report consists of three financial statements and explanatory notes. The financial statements are: 1) Statement of Revenues, Expenses, and Changes in Net Assets; 2) Statement of Net Assets; and 3) Statement of Cash Flows. The financial statements are designed to highlight the Lottery's operating activity and provide a snapshot of its financial condition.

A vital factor of the Lottery's financial statements is a statutory requirement that the Lottery transfer all net proceeds, less the amount allocated to the compulsive gambling prevention and treatment fund and a holdback of any reserve funds the Director may need for continuing operations, to the State Treasurer on at least an annual basis for deposit in the state's general fund. Accordingly, the primary focus of these financial statements is to determine the net proceeds that are available for transfer to the state's general fund. It is also important to note that most financial statement balances have a direct or indirect relationship to revenue. As lottery sales increase, the amount to be transferred to the state's general fund would also increase. Similarly, as lottery sales increase, there is a direct increase in prizes, retailer commissions, product group dues, and vendor fees.

Most of the assets included on the Statements of Net Assets represent current amounts, such as cash and accounts receivable from lottery retailers. Most liabilities represent current prizes, including prizes payable in North Dakota, prize reserve pool amounts payable to the Multi-State Lottery Association (MUSL), and amount due the state's general fund.

Financial Highlights

The Lottery is unique compared to all other state lotteries because it may only conduct multi-state online games. The constitution restricts the Lottery to multi-state games. The law restricts the Lottery to online games. Therefore, the Lottery may not conduct common in-state lotto games, instant ticket games, or pick 3 or 4 numbers games.

The Lottery is still relatively new and has few games. The Lottery enjoys broad public support in the play of its games and has achieved exceptional success in sales and net proceeds during its honeymoon period. The challenge facing the Lottery is to increase

sales and net proceeds by actively promoting sales of tickets for present and new games in a very competitive environment.

The Lottery launched its first game of Powerball on March 25, 2004, its second game of Hot Lotto on June 24, 2004, and its third game of Wild Card 2 on September 23, 2004.

Total prizes on winning tickets for the fiscal year ended June 30, 2005, were \$9,085,551, including prizes payable in North Dakota of \$4,073,561 and prizes payable to the MUSL to fund grand prizes of \$5,011,990. In addition, North Dakota had expired prizes in the amount of \$328,225.

When the Lottery adds a new game, a greater portion of each dollar of sales goes toward net proceeds since operating expenses such as salaries and fringe benefits, travel, telephone, and MUSL board dues are generally fixed and would not necessarily increase incremental to sales. Some operating expenses like advertising and marketing would increase. However, there are variable expenses that have a direct incremental relationship to sales like prizes, retailer commissions, product group dues, and vendor fees.

The Lottery's operating expenses are minimized because the Lottery blueprinted its organizational structure, functions, and gaming system features to optimize efficiency.

The Lottery earned \$6,464,895 of net proceeds. Of that amount \$260,489 was transferred to the compulsive gambling fund and \$5,838,005 to the state's general fund. It was initially projected that the Lottery would generate \$1.431 million for the state's general fund during the 2003-2005 biennium.

The Lottery's estimate for state general fund revenue is \$10 million for the 2005-2007 biennium.

Overview of the Financial Statements

Statement of Net Assets Summary:

Total Current Assets	\$ 6,493,820
Total Noncurrent Assets	536,001
Total Assets	<u>\$ 7,029,821</u>
Total Current Liabilities	\$ 6,513,750
Total Noncurrent Liabilities	54,229
Total Liabilities	<u>\$ 6,567,979</u>
Total Unrestricted Assets	<u>\$ 461,842</u>

Statement of Revenues, Expenses, and Changes in Net Assets Summary:

Total Operating Revenue	\$19,223,089
Total Operating Expense	12,818,529
Operating Income	\$ 6,404,560
Total Non-Operating Income	\$ 60,335
Net Proceeds before Operating Transfers	\$ 6,464,895
Total Transfers to Other Funds	6,098,494
Change in Net Assets	366,401
Total Net Assets, Beginning of Year	95,441
Total Net Assets, End of Year	\$ 461,842

Revenue:

Powerball Ticket Sales	\$13,207,729
Hot Lotto Ticket Sales	3,898,592
Wild Card 2 Ticket Sales	2,020,969
Total Ticket Sales	\$19,127,290
Other Operating Revenue	95,799
Total Revenue	\$19,223,089

Expenses:

Prize Expense	\$ 9,085,551
Retailer Commissions	956,365
Operating Expenses	2,776,613
Total Expenses	\$12,818,529

Net Proceeds:

Net Proceeds before Operating Transfers	\$ 6,464,895
Percent of Net Proceeds to Total Operating Revenue	33.6%

Online Gaming System

The Lottery executed an eight-year contract, effective March 25, 2004, with Scientific Games International, Inc. (Scientific Games) to provide the Lottery with online and secondary online gaming systems hardware, games management system software (GMS), satellite-based retailer telecommunications network, four hundred lottery terminals, electronic scrolling and logo backlit signs, primary and secondary internal control systems (ICS), and five field technicians to provide service to lottery retailers. The Lottery does not own any of this equipment. The GMS manages retailers and tracks and controls the sale of tickets, validation of winning tickets, and payments on winning tickets. The ICS's are independent databases of all retailer sales transactions that are controlled only by the Lottery, and are used for each draw to determine the number of winning tickets, by prize value.

The Lottery's online and secondary online gaming systems are co-located with the primary and secondary online gaming systems of the Montana Lottery at a computer data center located in Helena, Montana. The computer data center is owned by Scientific Games, which is the gaming system vendor for both the Montana Lottery and North Dakota Lottery. The Montana Lottery's contract with Scientific Games expires March 31, 2006. Since the Montana Lottery did not renew its online contract, Scientific Games is responsible for re-locating the North Dakota Lottery's online and secondary online gaming systems to another computer data center to ensure there is no interruption of service to the Lottery. The North Dakota Lottery's online gaming systems will be moved from Helena, Montana to another, (still unknown), Scientific Games central data center in February 2006.

Potential Factors Affecting Future Operations

By law, the Lottery is restricted to multi-state online games. The Lottery must partner with one or more other government-authorized lotteries to conduct a game. This restriction generally limits the Lottery to games sponsored by the MUSL. The MUSL may not have a broad range of games available to fulfill the Lottery's desired product mix. Should the MUSL disband, although it is not anticipated, the Lottery may not have a source of games to operate.

Looking Ahead

The Lottery's primary goal is to maximize revenue for the state's general fund. To accomplish this, the Lottery must offer exciting and attractive games that add value to the Lottery's product mix for players to play, license retailers that are in convenient locations to sell tickets, create effective annual marketing plans, provide quality customer service to retailers and players, and control operating expenses. Attractive games include a broad range of player odds and minimum jackpot prizes. The odds on a player winning any cash prize on a one dollar play may eventually range from one in three and one-half to one in thirty-six and six-tenths. The minimum jackpot may range from twenty thousand dollars to fifteen million dollars. The product mix may include up to five or six games.

Total sales of a game are dramatically affected by the size of the game's jackpot and, to a lesser degree, on the odds of winning a prize. Larger jackpots generate higher sales. However, larger jackpots cannot be predicted or counted upon. Therefore, a variety of games with varying jackpots and odds of winning a prize is necessary to attract players.

The Lottery has 400 licensed retailers located in 127 towns and cities, including all fifty-three counties. This is about one lottery terminal for each 1,586 residents. During the 2005-2007 biennium, the Lottery plans to:

1. Generate state general fund revenue of \$10 million;
2. Develop an inspiring slogan;
3. Launch two new games that add value to the Lottery's product mix;
4. Develop and conduct marketing promotions;
5. Develop an active and effective retailer outreach program;
6. Enable players to buy subscriptions to purchase tickets for draws for future periods of 13, 26, or 52 weeks; and
7. Conduct public and player surveys about the Lottery.

Compulsive Gambling Prevention and Treatment Fund

By law, starting July 1, 2005, fifty thousand dollars must be transferred to the State Treasurer each quarter for deposit in the compulsive gambling prevention and treatment fund.

The Lottery is sensitive to problem gambling and encourages players to play responsibly.

Contacting the Lottery

If a person has a question on any information in this report or desires additional information, the person should write to: North Dakota Lottery; Office of Attorney General; 600 E. Boulevard Avenue - Dept. 125; Bismarck, ND 58505-0040.

North Dakota Lottery
Statement of Net Assets
For the Fiscal Year Ended June 30, 2005

Assets:

Current Assets:

Cash and Cash Equivalents	\$ 6,355,745
Investments	1,000
Accounts Receivable	132,461
Prepaid Expenses	4,614
Total Current Assets	<u>\$ 6,493,820</u>

Noncurrent Assets:

Reserves on Deposit	\$ 536,001
Total Noncurrent Assets	<u>\$ 536,001</u>

Total Assets

\$ 7,029,821

Liabilities:

Current Liabilities:

Accounts Payable	\$ 290,539
Due to Other State Funds	5,844,362
Accrued Payroll	32,829
Prizes Payable	240,418
Deferred Revenue	93,637
Retailer Security Deposits	1,000
Compensated Absences Payable	10,965
Total Current Liabilities	<u>\$ 6,513,750</u>

Noncurrent Liabilities:

Compensated Absences Payable	\$ 54,229
Total Noncurrent Liabilities	<u>\$ 54,229</u>

Total Liabilities

\$ 6,567,979

Net Assets:

Unrestricted	\$ 461,842
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Total Net Assets

\$ 461,842

The accompanying Notes to the Financial Statements are an integral part of this statement.

NORTH DAKOTA LOTTERY
Statement of Revenues, Expenses and Changes in Net Assets
For the Fiscal Year Ended June 30, 2005

Operating Revenues:

Ticket Sales	\$ 19,127,290
Other Operating Revenue	95,799
Total Operating Revenues	<u>\$ 19,223,089</u>

Operating Expenses:

Prize Expense	\$ 9,085,551
Retailer Commissions	956,365
Contractual Services Expense	1,973,152
Marketing	209,627
Salaries and Benefits	360,931
Operating	232,903
Total Operating Expenses	<u>\$ 12,818,529</u>

Operating Income	<u>\$ 6,404,560</u>
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Nonoperating Revenues:

Interest Income	<u>\$ 60,335</u>
Total Nonoperating Revenues	<u>\$ 60,335</u>

Income Before Transfers	<u>\$ 6,464,895</u>
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Transfers to Other Funds:

Compulsive Gambling Fund	\$ 260,489
State General Fund	5,838,005
Total Transfers to Other Funds	<u>\$ 6,098,494</u>

Change in Net Assets	\$ 366,401
Total Net Assets – Beginning of Year	95,441
Total Net Assets – End of Year	<u>\$ 461,842</u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

NORTH DAKOTA LOTTERY
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2005

Cash Flows from Operating Activities:

Ticket Sales	\$ 14,739,550
Other Revenues	77,133
Paid to Prize Winners	(573,801)
Paid to Vendors	(7,476,900)
Paid to Employees	(364,641)
Reserves on Deposit	(457,742)
Net Cash Provided by Operating Activities	<u>\$ 5,943,599</u>

Cash Flows from Noncapital Financing Activities:

Paid to Compulsive Gambling Treatment Fund	\$ (400,000)
Paid to State General Fund	(1,432,434)
Net Cash Used in Noncapital Financing Activities	<u>\$ (1,832,434)</u>

Cash Flows from Investing Activities:

Interest Income	\$ 31,261
Net Cash Provided by Investing Activities	<u>\$ 31,261</u>

Cash and Cash Equivalents at Beginning of Year	<u>\$ 2,213,319</u>
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Cash and Cash Equivalents at End of Year	<u>\$ 6,355,745</u>
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Reconciliation of Operating Income to Net Cash Provided by Operating Activities:

Operating Income	\$ 6,404,560
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:	
Changes in Assets and Liabilities:	
(Increase) Decrease in Accounts Receivable	20,003
(Increase) Decrease in Due from Other State Funds	1,332
(Increase) Decrease in Prepaid Expenses	(1,120)
(Increase) Decrease in Reserves on Deposit	(457,742)
Increase (Decrease) in Accounts Payable	(89,994)
Increase (Decrease) in Accrued Payroll	3,844
Increase (Decrease) in Compensated Absences Payable	(6,986)
Increase (Decrease) in Prizes Payable	45,974
Increase (Decrease) in Due to Other State Funds	5,979
Increase (Decrease) in Other Current Liabilities	17,749
Total Adjustments	<u>\$ (460,961)</u>
Net Cash Provided by Operating Activities	<u><u>\$ 5,943,599</u></u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

North Dakota Lottery
Notes to the Financial Statements
For the Fiscal Year Ended June 30, 2005

Note 1. Summary of Significant Accounting Policies

Organization

On November 5, 2002, North Dakota citizens approved a constitutional amendment that enables the state to participate in multi-state lottery games. The 2003 Legislative Assembly passed House Bill No. 1243 that became law on April 4, 2003. This law, chapter 53-12.1 (Lottery) of the North Dakota Century Code, created the North Dakota Lottery as a division within the Office of Attorney General. The law restricts the Lottery to multi-state online games. In-state lotto games, instant ticket games, and pick 3 or 4 numbers games are prohibited.

The mission of the Lottery is to maximize net proceeds for the benefit of the state by promoting entertaining games, providing quality customer service to retailers and players, achieving the highest standards of integrity, security, and accountability, and maintaining public trust.

The Lottery is our state's newest government-sponsored business enterprise. The Lottery manages, regulates, and promotes this business. As a business, the Lottery must be profitable in the eyes of the Legislature. To be profitable, the Lottery must prosper, have a positive public image, and players must be confident that games are fair and honest. The success of the Lottery will depend on how well the Lottery is managed, the variety of games that are available to players, and how effectively games are promoted.

The Lottery is a member of the Multi-State Lottery Association (MUSL). The Lottery has been authorized to conduct the games of Powerball, Hot Lotto, and Wild Card 2. As of August 28, 2005, the Powerball matrix is a 5 of 55 and 1 of 42 game. Powerball was launched on March 25, 2004. The Hot Lotto matrix is a 5 of 39 and 1 of 19 game. Hot Lotto was launched on June 24, 2004. The Wild Card 2 matrix is a 5 of 31 and 1 of 16 game. Wild Card 2 was launched on September 23, 2004. Drawings for Powerball, Hot Lotto, and Wild Card 2 are held each Wednesday and Saturday evenings.

To play the Power Play option on a Powerball ticket, a player pays an additional one dollar per play for an opportunity to multiply the player's set prize (excluding the grand prize) by 2, 3, 4, or 5. Before each Powerball drawing, the Power Play prize multiplier number is selected for that draw.

Reporting Entity

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, the Lottery should include all component units over which the Lottery exercises such aspects as: (1) appointing a voting majority of an organization's governing body; (2) has the ability to impose its will on that organization;

or (3) the potential for the organization to provide specific financial benefits to, or impose specific burdens on, the Lottery.

Based on the criteria of GASB Statement No. 14, no organization was determined to be part of the Lottery as a reporting entity. The Lottery is a division of the Office of Attorney General which is part of the primary government of the state of North Dakota.

Basis of Accounting and Measurement Focus

The Lottery's activity is accounted for as a proprietary type enterprise fund for the State of North Dakota. A proprietary fund is accounted for using the accrual basis of accounting. Revenues are recognized when they are earned and expenses are recognized when they are incurred.

An enterprise fund is used to account for an activity that is financed and operated in a manner similar to a private business enterprise where the costs of providing goods or services to the public on a continuing basis are financed through the sale of those goods or services. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. An enterprise fund is accounted for by using the economic resources measurement focus in which all assets and liabilities associated with the operation of the funds are included on the statement of net assets. Net assets are segregated into investments in capital assets and restricted and unrestricted components. The statement of revenues, expenses, and changes in net assets present increases, like revenues, and decreases, like expenses, in total net assets. The statement of cash flows presents the cash flows for operating, investing, and non-capital financing activities.

The lottery law prescribes (except for the initial startup funding to the Lottery), general fund monies of the state may not be used or obligated to pay expenses or prizes of the Lottery.

Accounting Standards

The Lottery follows the pronouncements of the GASB, which is the nationally accepted standard-setting body for establishing generally accepted accounting principles for governmental entities. In accordance with GASB Statement No. 20, the Lottery follows all applicable GASB Pronouncements and Financial Accounting Standards Board pronouncements issued on or before November 30, 1989 unless those pronouncements conflict with GASB pronouncements.

The preparation of financial statements in conformity with generally accepted accounting principles requires the Director to make estimates and presumptions that affect reported amounts of assets, liabilities, income, and expenses. Actual results could differ from those estimates.

Operating and Nonoperating Revenues

An enterprise fund distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the proprietary fund's principal ongoing operation. The principal operating revenue of the Lottery is sales of tickets.

Operating expenses of the Lottery include prizes, retailer commissions, contractual services, marketing, and salaries and fringe benefits. All revenue and expenses not meeting the criteria are reported as nonoperating income and expenses.

Cash and Cash Equivalents

Cash and cash equivalents are defined as deposits with the Bank of North Dakota and the State Treasurer. The Lottery does not invest in marketable securities.

Retailer Security Deposits

If retailers have an unsatisfactory credit rating, the Lottery requires those retailers to provide the Lottery a security deposit to protect the Lottery from bad debts. Security may be in the form of a performance bond, deposit in cash, an irrevocable letter of credit, or a certificate of deposit. Security deposits in the form of checks or certificates of deposit are classified as assets. Security deposits in the form of letters of credit or performance bonds are classified as collateral.

Accounts Receivable

Accounts receivable primarily represents lottery funds due from retailers for ticket sales, less commissions and prizes on winning tickets paid by retailers. Lottery funds are collected weekly through electronic funds transfer by the Lottery from retailers' bank accounts. The Lottery has not incurred and does not project any bad debts.

Reserves on Deposit

The Lottery has \$536,001 on deposit with the MUSL related to the Prize Reserve Pools. See Note 6.

Prepaid Expenses

Prepaid expenses of \$4,614 are retailer commissions on future sales.

Furniture, Fixtures, and Equipment

The Lottery has no capitalized furniture, fixtures, or equipment. A fixed asset is capitalized if it has a useful economic life of more than one year, is tangible, and has a unit cost of \$5,000 or more. Depreciation would be computed using the straight-line method over the asset's estimated useful economic life.

Prizes

Prize expense is recorded based on actual drawing results.

Prizes payable represents the difference between the amount of prize expense recognized and actual prizes paid.

Players may redeem winning tickets for up to 180 days after the draw for the game. As of June 30, 2005, unclaimed prizes were \$224,827. Prizes in the amount of \$328,225 expired in the June 30, 2005 fiscal year, \$0 expired in the June 30, 2004 fiscal year.

Deferred Revenue

A liability has been recorded for lottery tickets sold on or before June 30, 2005 on multiple draw tickets that contain plays for future draws that will occur after June 30, 2005. The amount related to future sales of \$92,283 is classified as deferred revenue. Sales of uncashed gift certificates in the amount of \$1,354 are also classified as deferred revenue.

Interfund Balances and Transfers

At June 30, 2005, the Lottery had nominal accounts payables and receivables involving normal business expenses with several state agencies and had net proceeds due to be transferred to one state fund.

By law, the net proceeds of the Lottery, less the amount allocated to the compulsive gambling prevention and treatment fund and a holdback of any reserve funds the Director may need for continuing operations, must be transferred to the State Treasurer on at least an annual basis for deposit in the state's general fund. By law, 5% of the Lottery's gross profit, up to four hundred thousand dollars during the 2003-2005 biennium, must be transferred to the compulsive gambling prevention and treatment fund. The reserve funds held by the Director are funds that are required to be transferred to the MUSL for prize reserve pools. The balance of the net proceeds is transferred to the state general fund.

Retailer Commissions

Lottery retailers that sell tickets receive a 5% commission on each ticket sold or distributed to players. The Lottery does not offer retailers a commission for redeeming winning tickets or a bonus for sales incentives or for selling a jackpot prize winning ticket. Retailer commissions were \$956,365.

Marketing and Advertising

Costs incurred for developing creative point-of-sale items, research, and media advertising are expensed when incurred which generally is when point-of-sale items are first distributed to retailers or advertising first takes place.

Accumulated Unpaid Vacation, Sick Pay, and Compensatory Pay

Annual leave and sick leave are a part of permanent employees' compensation as set forth in Section 54-06-14 of the North Dakota Century Code. Annual leave is earned based on tenure of employment, within a range of a minimum of one working day per month of employment, to a maximum of two working days per month of employment, to be fixed by rules and regulations adopted by the employing unit. In general, accrued annual leave cannot exceed 30 days at each year-end, as set by the Office of Attorney General. Employees are paid for unused annual leave upon termination or retirement.

Sick leave is earned at the rate of one working day per month of employment. There are no limitations on the amount of sick leave that an employee can accumulate. Employees who have ten continuous years of service are paid one-tenth of their

accumulated sick leave upon termination or retirement under chapter 54-52 of the North Dakota Century Code. A liability is recognized for that portion of accumulated sick leave benefits that is estimated will be taken as required by the GASB Statement No. 16, *Accounting for Compensated Absences*.

Compensatory leave is earned by employees who work overtime each week in accordance with the Office of Attorney General's policy. Generally, upon termination or retirement, employees are not eligible to receive compensation for their compensatory leave balances.

Note 2. Compensated Absences

A summary of compensated absences follows:

Beginning balance, July 1, 2004	\$72,180
Addition	
Reduction	6,986
Ending balance, June 30, 2005	<u>\$65,194</u>
Amount payable within one year	<u>\$10,965</u>

Note 3. Due to / Due from Other State Funds

At June 30, 2005, accounts payable due to several state agencies and transfers of net proceeds due to one state fund are:

Due to the Department of Transportation	\$ 2,135
Due to the Information Technology Department	1,483
Due to the Office of Management & Budget	532
Due to the Office of Attorney General	3,641
Due to the State General Fund	<u>5,836,571</u>
Total	<u>\$5,844,362</u>

At June 30, 2005 no amount was due from other state funds.

Note 4. Employee Pension Plan

The Office of Attorney General participates in the North Dakota Public Employees' Retirement System (NDPERS) administered by the state of North Dakota. The following is a brief description of the plan.

NDPERS is a cost-sharing multiple-employer defined benefit pension plan covering substantially all classified employees of the Office of Attorney General. The plan provides retirement, disability, and death benefits. If an active employee passes away with less than three years of credited service, a death benefit equal to the value of the employee's accumulated contributions, plus interest, is paid to the employee's beneficiary. If the employee has earned more than three years of credited service, the surviving spouse is entitled to a single payment refund, life-time monthly payments in an amount equal to 50% of the employee's accrued normal retirement benefit, or 60 monthly payments equal to the employee's accrued normal retirement benefit calculated as if the employee were age 65 the day before death occurred or monthly payments in

an amount equal to the employees' accrued 100% joint and survivor retirement benefit if the member had reached normal retirement age prior to date of death. If the surviving spouse passes away before the employee's accumulated pension benefits are paid, the balance is payable to the surviving spouse's designated beneficiary.

Eligible employees who become totally disabled after a minimum of 180 days of service receive monthly disability benefits that are equal to 25% of their final average salary with a minimum benefit of \$100. To qualify under this section, the employee must meet the criteria established by the Retirement Board for being considered totally disabled.

Employees are entitled to unreduced monthly pension benefits equal to 2.00% of their final average salary for each year of service beginning when the sum of age and years of credited service equal or exceed 85, or at normal retirement age (65). The plan permits early retirement at ages 55-65, with three or more years of service.

Benefit and contribution provisions are administered in accordance with chapter 54-52 of the North Dakota Century Code. This state statute requires that 4% of the participant's salary be contributed to the plan by either the employee or by the employer under a "salary reduction" agreement. The Office of Attorney General has implemented a salary reduction agreement and is currently contributing the employees share. The Office of Attorney General is required to contribute 4.12% of each participant's salary as the employer's share. The required contributions are determined using an entry age normal actuarial funding method. The North Dakota Retirement Board was created by the State Legislature and is the governing authority of NDPERS. The Office of Attorney General required an actual contribution to NDPERS for the fiscal years ended June 30, 2005 and June 30, 2004 of \$24,235 and \$14,738, respectively.

NDPERS issues a publicly available financial report that includes financial statements and the required supplementary information for NDPERS. That report may be obtained by writing to NDPERS; 400 East Broadway, Suite 505, PO Box 1214, Bismarck, ND 58502-1214.

Note 5. Multi-State Lottery Association

The Lottery is a member of the MUSL which administers games on behalf of member lotteries. MUSL administers the Powerball, Hot Lotto, and Wild Card 2 games for the Lottery. Each member lottery sells game tickets through its retailers and makes weekly wire transfers to MUSL in an amount equivalent to the member lottery's share of the estimated grand prize liability. If this results in a negative amount, the MUSL transfers funds to the Lottery. Lesser prizes are paid directly to the winners by each member lottery. The prize pools for Powerball and Hot Lotto are 50% of each drawing period's sales, after the prize reserve accounts are funded to the amounts set by the Product Group. The prize pool for Wild Card 2 is 55%. Up to 2% of sales for Powerball and Hot Lotto are deducted from the prize pool and placed in prize reserve funds. For Hot Lotto, up to 1% of sales is deducted from the prize pool and placed in a prize reserve fund when the Grand Prize exceeds \$2,000,000. An additional 2% of sales is placed in the prize reserve fund after the annuitized Grand Prize exceeds \$5,000,000. Once the prize reserve funds exceed the designated caps, the excess becomes part of the prize pool.

The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities and the money in this reserve fund is used at the discretion of the MUSL Board of Directors. The prize reserve fund monies are refundable to MUSL members if MUSL disbands or if a member leaves MUSL. Members leaving MUSL must wait one year before receiving their remaining share, if any, of the prize reserve funds. Any amount remaining in the prize pools at the end of the games shall be carried forward to a replacement game or expended in a manner as directed by the Product Group. The MUSL Prize Reserve Pool account balance and the Lottery's share of that balance are as follows:

	<u>6/30/2005</u>	<u>6/30/2004</u>
MUSL Prize Reserve Pool account balance	\$100,162,066	\$94,050,041
Lottery's share of the MUSL's account balance (on deposit)	\$536,001	\$78,259
Lottery's present amount due the MUSL	\$4,841	\$15,748
Lottery's future amount due the MUSL	\$471,631	\$677,244

The Lottery also has an unreserved fund with MUSL. Interest earned on the MUSL funds and any unclaimed grand prizes may be deposited into this account and game membership fees and other MUSL costs may be paid from this fund.

	<u>6/30/2005</u>	<u>6/30/2004</u>
MUSL Unreserved Fun Account Balance	\$11,961,734	\$9,737,349
Lottery's share of the MUSL's account balance	(\$58,080)	(\$18,028)

A winner of a Powerball or Hot Lotto grand prize may select that the prize be paid at the cash value of the prize or as an annuity. A Powerball grand prize is paid out in 30 installments and a Hot Lotto grand prize in 25 installments. Effective August 28, 2005, Powerball annuitized prizes are paid annually in 30 graduated payments (increasing each year) by a rate determined by the Powerball product group. If a grand prize winner selects annual installments, the MUSL buys United States zero coupon bonds in the name of the member lottery that becomes the beneficiary. Winner Trusts hold securities used to fund the MUSL's payment of cash to the member lotteries so the lotteries can, as obligated, pay winning players when annuitized payments are due. The source of this money is a product group's Grand Prize Pool. The assets and related liabilities are reflected in the MUSL's financial statements and therefore, are not reflected in the Lottery's financial statements. MUSL is responsible for transferring the cash or the annuity installment amounts to the member lottery prior to the payment to the grand prize winner. The Lottery currently is not paying any prize winner an annuity prize payment. The Wild Card 2 grand prize is paid in cash. The Powerball, Hot Lotto, and Wild Card 2 Grand Prizes are divided equally among multiple winners.

As a member of the MUSL Board, the Powerball, Hot Lotto, Wild Card 2, and CrossMatch (new game in development) product groups, the Lottery is responsible for its pro-rated share of the MUSL Board dues, product group dues and fees, and equipment costs as follows:

MUSL Board dues	\$51,514
MUSL Powerball product group dues	\$12,425
MUSL Hot Lotto product group dues	\$7,285
MUSL Wild Card 2 product group dues	\$12,797
MUSL CrossMatch product group fees	\$5,000

Note 6. Commitments and Contingencies

The Lottery entered into contracts with:

1. Scientific Games International, Inc. of Alpharetta, GA on February 3, 2004. The vendor provides an online lottery gaming system and related services through March 24, 2012, with a possible extension through March 24, 2014. Payments for fiscal years ended June 30, 2005 and 2004 totaled \$1,973,152 and \$606,060, respectively. The North Dakota Lottery's future variable obligation is based on 10.63% of sales, there are no minimum fees;
2. H2M of Fargo, ND on February 2, 2004. The vendor provides marketing and related services through June 30, 2007. Payments to H2M for fiscal years ended June 30, 2005 and 2004 totaled \$175,188 and \$237,418. The North Dakota Lottery's future obligation is for services requested, there is no minimum fee or retainer fee; and
3. A & U Security, LLC, of Helena, MT on March 8, 2004. The vendor provides standby services and, if necessary, security of the Scientific Games International, Inc.'s computer data center on days of the drawings through March 26, 2007. The expense for the fiscal years ended June 30, 2005 and 2004 was \$420. Minimum future compensation is \$420 per year. The contract may be terminated upon 30 days' written notice.

The Lottery has a contingent gain estimated at \$204,970 from prizes that may be forfeited due to winners not claiming them within the required time frame. This contingent gain has not been accrued in these financial statements but will be recognized when realized.

Note 7. Line of Credit

In accordance with subsection 2 of section 53-12.1-02 of the North Dakota Century Code, the Lottery has secured a short-term line of credit with the Bank of North Dakota. The law provides that the line of credit be limited to the amount of each cash prize of \$100,000 or more that relates to prize funds known to be due and forthcoming to the Lottery from other government-authorized lotteries through the Multi-State Lottery Association. The line of credit may not exceed \$1 million in the aggregate. To date, no advances have been requested.

Note 8. Risk Management

The Lottery is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Lottery, as a division of the Office of Attorney General, participates in the same funds/pools established by the state for risk management issues, including:

The 1995 Legislative Assembly established the Risk Management Fund (RMF), an internal service fund, to provide a self-insurance vehicle for funding the liability exposures of state agencies resulting from the elimination of the State's sovereign immunity. The RMF manages the tort liability of the state, its agencies' employees, and the University System. All state agencies participating in the RMF and their fund contribution was determined using a projected cost allocation approach. The statutory liability of the state is limited to a total of \$250,000 per person and \$1,000,000 per occurrence.

The Office of Attorney General also participates in the North Dakota Fire and Tornado Fund and the State Bonding Fund. The office pays an annual premium to the Fire and Tornado Fund to cover property damage to building and personal property. Replacement cost coverage is provided by estimating replacement cost in consultation with the Fire and Tornado Fund. The Fire and Tornado Fund is reimbursed by a third party insurance carrier for losses in excess of \$1 million per occurrence during a 12-month period. The State Bonding Fund currently provides the agency with blanket employee fidelity bond coverage in the amount of \$2,500,000. The State Bonding Fund does not currently charge any premium for this coverage.

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Honorable John Hoeven, Governor
Members of the Legislative Assembly

Chuck Keller, Director
North Dakota Lottery

We have audited the financial statements of the business-type activities of the North Dakota Lottery, as of and for the year ended June 30, 2005, which collectively comprise the North Dakota Lottery's basic financial statements and have issued our report thereon dated October 21, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the North Dakota Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the North Dakota Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused

by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be a material weakness. However, we noted other matters involving the internal control over financial reporting that we have reported to management of the North Dakota Lottery, in a separate letter dated October 21, 2005.

This report is intended solely for the information of the Governor, Legislative Audit and Fiscal Review Committee, North Dakota Lottery Advisory Commission, and management of the North Dakota Lottery and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Robert R. Peterson
State Auditor
October 21, 2005

NORTH DAKOTA LOTTERY

SPECIAL COMMENTS REQUESTED BY THE LEGISLATIVE AUDIT AND FISCAL REVIEW COMMITTEE

For The Year Ended June 30, 2005

The Legislative Audit and Fiscal Review Committee requires that certain items be addressed by auditors performing audits of state agencies. These items and our responses are as follows:

1. Were expenditures made in accordance with legislative appropriations and other state fiscal requirements and restrictions?

The North Dakota Lottery has a continuing appropriation, per section 53-12.1-09 of the North Dakota Century Code.

2. Were revenues accounted for properly?

Yes.

3. Were there adequate financial controls and procedures?

Yes.

4. Was the system of internal control adequate and functioning effectively?

Yes

5. Do financial records and reports reconcile with state fiscal offices?

Yes.

6. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Yes

7. Was there any indication of fraud or dishonesty?

No.

8. Were there any indications of lack of efficiency in financial operations and management of the agency?

No.

9. Has action been taken on findings and recommendations included in prior audit reports?

Yes.

10. Were all activities of the agency encompassed within appropriations of specific amounts?

No. The North Dakota Lottery has a continuing appropriation, per section 53-12.1-09 of the North Dakota Century Code.

11. Has the agency or institution implemented the Statewide Accounting and Management Information System (SAMIS) including the cost allocation system?

Yes. The North Dakota Lottery has implemented ConnectND.

12. Has the agency developed budgets of actual anticipated expenditures and revenues on at least a quarterly basis and compared on at least a quarterly basis actual expenditures and revenues on the accrual basis to budgeted expenditures and revenues?

Yes.